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No More Tax Stimulus

By Augustine Faucher in West Chester
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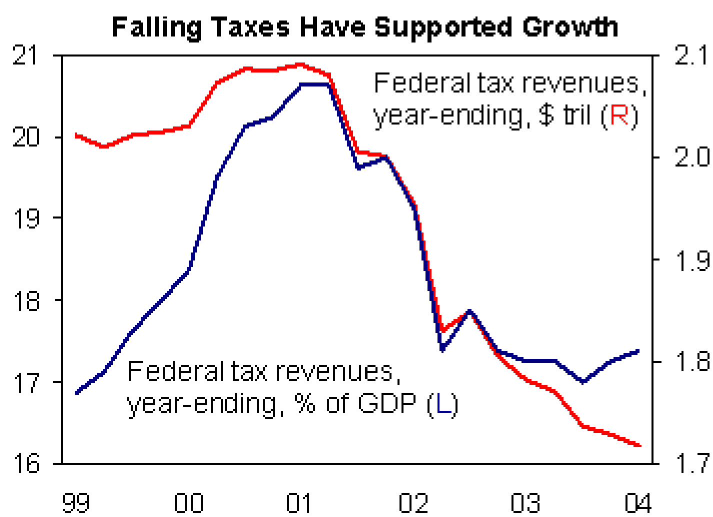
Fiscal Policy

Despite the slow recovery in the labor market, the recession of 2001 was one of the mildest on record. One reason for the shallow recession was federal fiscal policy, on both the tax and spending sides. But with the economy strengthening and legislated tax cuts having run their course, federal revenues are no longer falling and taxes will be a weight on economic growth in the months ahead.

As a share of GDP, total federal taxes have fallen from almost 21% in 2000 to just above 16% currently (see chart), or by more than $200 billion annually. Taxes have declined for two reasons. First, obviously, are the various tax cuts that have been enacted into law over the past three years, primarily the personal income tax cuts of 2001 and 2003 and the corporation tax cuts of 2002.



Second is the impact of the weaker economy on revenues. Taxes are tied to economic activity: employment, wages and salaries, corporate profits, investment returns. When the economy is weak, the revenue base contracts or grows more slowly, and tax revenues decline as a result. The progressive nature of the U.S. personal income tax system amplifies this result; when incomes drop during a recession, the average tax rate declines. Therefore, even without legislated changes, tax policy provides fiscal stimulus during economic downturns. This is known as “automatic stabilization” and is a deliberate component of the U.S. tax system, designed to reduce the severity of recessions.

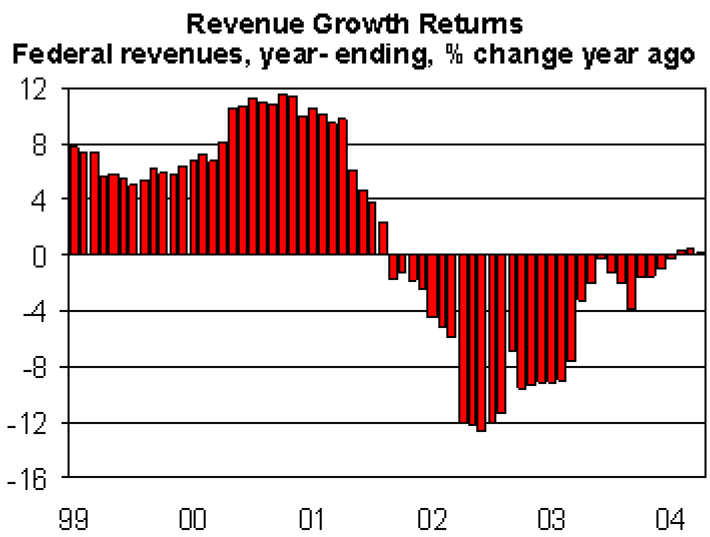
According to Economy.com estimates, each of these factors, legislated tax cuts and automatic stabilizers, accounts for roughly one-half of the decline in federal revenues since 2000. Together, they have provided important Keynesian stimulus to the economy, although one could certainly argue that the tax cuts could have been better targeted to provide more “bang for the buck” in terms of their impact on short-run economic growth.

Still, tax cuts, automatic stabilizers, massive growth in federal spending and very loose monetary policy all worked together to limit the negative impact of the recession. According to the National Bureau of Economic Research, the 2001 recession lasted just eight months, shorter than the average for the post-World War II period, and real GDP fell just 0.5%, peak to trough, the mildest contraction over this same period. Tax cuts supported growth in disposable incomes when the labor market was weak and were a major reason why real personal consumption expenditures were never negative on a year-ago basis, unusual for a recession.

Now, however, there is little stimulus left on the tax side. For one, legislated tax cuts have largely run their course. The tax cut enacted last year moved up marginal rate reductions scheduled for 2004 and 2006, retroactive to the beginning of 2003. However, because the legislation was not passed until well into 2003, lower withholding did not start until the second half of last year. This means that there will be some stimulus from lower withholdings on a year-ago basis through the first half of 2004, but nothing beyond that.

Also, personal income tax refunds paid out in 2004, on income earned last year, are running slightly ahead of the 2003 pace because of the retroactive nature of last year's tax cut. Still, refunds are only 7% above last year, well below the 25% implied by Treasury Department projections. This means that tax refunds will provide less of a boost to consumer spending this year than originally expected.

At the same time, the improving economy is also leading to stronger growth in revenues. In particular, corporation income tax revenues are up more than 35% through the first seven months of FY2004, after accounting for a timing change, because of rapid gains in corporate profitability. Withheld individual income tax receipts are up 1% over this same period, despite the fact that the withholding rate has been lower. Overall, through the first seven months of the fiscal year, which began on October 1, federal tax receipts are up more than 1% over the same period in FY2003. This may not be much, but it compares to average annual declines of more than 4% from FY2000 to FY2003 (see chart below).



All of this indicates that tax policy will soon turn from a positive for economic growth to a negative. This is not entirely a bad thing; for example, the automatic stabilizers implicit in the tax code will work to contain growth going forward, limiting inflationary pressures and reducing the degree of monetary tightening by the Federal Reserve. And greater revenues will help reduce the big budget deficits the U.S. is currently facing, a major threat to long-term growth, although gains will be insufficient to completely close the gap without legislated tax increases or big spending cuts. Still, after three years of supporting short-run economic growth, federal taxes will soon weigh on it.

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